No. 14852.

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

C. A. SWANSON & SONS POULTRY COMPANY,

Appellant,

vs.

WILLIAM A. WYLIE, Trustee in Bankruptcy for the Manuel Delatorre, dba R & M Egg Farms, Bankrupt,

Appellee.

APPELLEE'S BRIEF.

CRAIG, WELLER & LAUGHARN,
By C. E. H. McDONNELL,
111 West Seventh Street,
Los Angeles 14, California,
Attorneys for Appellee William A. Wylie.

FRANK C. WELLER,
C. E. H. McDONNELL,
THOMAS S. TOBIN,
Of Counsel.

Parker & Son, Inc., Law Printers, Los Angeles. Phone MA. 6-9171.

TOPICAL INDEX

TABLE OF AUTHORITIES CITED

Cases

Statute

Textbook

No. 14852.

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

C. A. SWANSON & SONS POULTRY COMPANY,

Appellant,

vs.

WILLIAM A. WYLIE, Trustee in Bankruptcy for the Manuel Delatorre, dba R & M Egg Farms, Bankrupt,

Appellee.

APPELLEE'S BRIEF.

Statement of Facts.

In the "Appellant's Opening Brief", pages 2 and 3, appears a "Statement of the Case" which, no doubt, through inadvertence, fails to summarize before this court all the pertinent facts which appear in the record.

Manuel Delatorre operated a business known as the "R & M Egg Farms" [Tr. 40].

Originally, the business had been a partnership between Delatorre and Bone [Tr. 40] but on May 29, 1953 Bone died and the business was continued by Delatorre, individually.

Delatorre's principal supplier, both before and after the death of Bone, had been the defendant here, C. A.

Swanson & Sons Poultry Company, supplying about sixty per cent of the eggs for his wholesale operation [Tr. 41]. The eggs were purchased on a credit arrangement which, according to Delatorre, permitted payment thirty days after the eggs were purchased [Tr. 41]. Elmo Cross, the assistant manager of Swanson [Tr. 71], testified in contradiction that the credit terms had always been two weeks [Tr. 72].

After Bone's death, and perhaps before, Delatorre had given to the defendant a number of checks which were returned NSF [Tr. 47, 72].

About May 1, 1953, after a number of the checks had been returned NSF, the defendant reduced Delatorre's credit terms to ten days [Tr. 41]. This was done by the defendant at a meeting in the defendant's office at which time Elmo Cross stated, according to Delatorre, that "things didn't look so good, so that he was going to cut my credit down" [Tr. 42]. About June 1 [Tr. 42] Elmo Cross and Elliott, the accountant and credit manager of the defendant [Tr. 93], paid a visit to Delatorre's place of business. They went through Delatorre's books, all of which were made available to them. After inspecting the books, an inventory was taken of all the fixtures and trucks on the premises by Cross and Elliott who demanded of Delatorre that he execute a chattel mortgage to secure the indebtedness then due to the defendant [Tr. 42, 43]. This mortgage was prepared in the office of the defendant and a few days later Delatorre went there and signed it [Tr. 43]. This mortgage, dated June 12, 1953, is plaintiff's Exhibit 1 [Tr. 44, 45].

At the time of the meeting about June 1, 1953, the defendant stopped all credit sales to Delatorre and advised

him to go out and buy his eggs from other sources so that he could pay Swanson [Tr. 49, 50].

Also after the chattel mortgage was requested, defendant refused to accept any more checks of Delatorre and insisted on certified checks and cash [Tr. 47, 48].

As early as November 26, 1952 the books of the bankrupt, then a partnership, showed an insolvent condition in that the liabilities exceeded the assets by $1,722.12 [Tr. 32]. At the time of Bone's death on March 29, 1953 an audit was made of the books of the partnership and it was determined that the business was insolvent with an excess of liabilities over assets of $15,291.00 [Tr. 37], and this was a condition which did not improve after March 29, 1953 to the date of bankruptcy [Tr. 39].

Only two of the payments alleged in the complaint were ever questioned in this matter. One of them is a check given originally May 29, 1953 in the sum of $1,632.00 [Tr. 34]. This check was presented for payment and on June 3, 1953 returned by the Bank of America to the defendant [Tr. 34]. On June 10, 1953 a new check on a new bank was drawn by Delatorre in the sum of $1,632.00, was presented for payment on the same day and cleared the bank [Tr. 34].

The other item of payment about which some question has been raised is clarified by the undisputed testimony of Thomas Mulherin, a C. P. A., on page 35 of the record. This is an item of $1,963.84. This was a check returned June 3, 1953. On June 22 a cashier's check was obtained from Delatorre's new bank in lieu of the original check for $1963.84.

ARGUMENT.

Although it is not entirely clear from the appellant's opening brief, appellee apprehends that the appellant complains of the decision in this matter on the ground that the burden of proof as to three elements has not been sustained by the plaintiff: namely, the demonstration of insolvency, of reasonable cause to believe therein, and that a "preference actually resulted" (which no doubt refers to the requirement of Section 60a of the Bankruptcy Act that a preference occurs when payments are made which "* * * will * * * enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class.")

Appellee proposes to examine each of the three requirements raised and contends that the burden of proof under the law has been amply sustained in each case.

I.

Manuel Delatorre Was Demonstrated to Have Been Insolvent at the Time of All Payments Here Sought To Be Recovered as Preferential.

It is not necessary to belabor the facts in the above matter since Appellant conceded that an insolvent condition existed. Appellee quotes from page 2 of the "Appellant's Opening Brief":

> "That bankrupt had been fairly prompt in his payment until his partner died about May 29, 1953, at which time his checks commenced to return from the bank. *Although the liabilities at that time exceeded the assets,* a fact known to the surviving partner and his accountant, * * *." (Emphasis supplied.)

This statement is in accordance with the statement made by counsel for the appellant at the time of trial [Tr. 69]:

> "Secondly, the plaintiff must prove the insolvency of the bankrupt. The fact of bankruptcy itself is some proof *and I don't think anybody is going to argue that the bankrupt was insolvent the last two or three months of his existence in business.*" (Emphasis supplied.)

Thus, it can be seen that the appellant itself now by its brief and its statement at trial has conceded the insolvency. If more was needed, the court's attention is directed to the testimony of the accountant for Delatorre, which indicates on page 39 of the record that on March 29, 1953 an insolvent condition of $15,291.00 existed, which did not improve thereafter until the time of bankruptcy [Tr. 39].

II.

The Payments to Swanson Enabled It to Obtain More Payment on Its Debt Than Was Made to Other Creditors of the Same Class.

The court's attention is directed to the uncontradicted testimony of Delatorre appearing at page 102 of the record:

> "Q. (By Mr. McDonnell): Mr. Delatorre, the plaintiff has alleged here and I think it is now substantially admitted, that after May 29, 1953, you paid to the C. A. Swanson & Sons $12,267 on this account.
>
> Keeping in mind your other creditors, did any of your other creditors receive similar payments—not in that amount but percentagewise on their accounts during that time? A. They did.
>
> Q. Did all of your creditors receive similar payments? A. *Well, not all of them.*

Q. *There were some that did not receive as much?*
A. *That is right.*" (Emphasis supplied.)

On cross-examination, Delatorre reiterated the evidence on direct examination. Delatorre indicated that there was at least two of his creditors to whom he never paid a penny [Tr. 103]:

> "Q. (By Mr. Obrand): And they received payments also in June and July? A. Well, I don't think so. *There was Harris Produce. I never even got a chance to give them a nickel or Great West Egg Company.*" (Emphasis supplied.)

In view of the foregoing uncontradicted testimony, appellee contends that no other conclusion would have been possible to the trial court other than the one it reached: that the payments to Swanson enabled it to secure a greater percentage of payment on its claim against Delatorre than were received by others of his creditors.

III.

The Appellant Had Reasonable Cause to Believe That the Debtor Delatorre Was Insolvent When It Received Payments on the Antecedent Debt Totaling $12,267.05.

A careful reading of both appellant's brief here and the record made at the time of trial will indicate that the main contention in this matter has always been that the appellant did not know Delatorre was insolvent until bankruptcy was filed and never had reasonable cause to believe that he was.

With this contention of the appellant the trial court disagreed, finding [Tr. 5]:

> "That on May 29, 1953, and at all times thereafter, defendants, and each of them herein, had rea-

sonable cause to believe that the bankrupt, Manuel Delatorre, was insolvent."

Let us be clear at once that it is not incumbent on the plaintiff to demonstrate that there was actual knowledge of insolvency. Remington on Bankruptcy, 5th Ed., puts the matter this way in Section 1709:

> "The trustee need not prove absolute knowledge, but only such circumstances as would lead an intelligent and prudent business man to entertain the belief that the transfer would give him a preference over other creditors. * * * Direct evidence may be unobtainable. But this is not essential. The creditor comes within the inhibition where the substantial facts are of such significance as fairly to warrant the inference that he knew or ought to have known of the bankrupt's financial condition."

The existence of "reasonable cause to believe" is a question of fact. The leading case is *Kaufman v. Tredway,* 195 U. S. 271, 49 L. Ed. 190, 25 S. Ct. 33, wherein Mr. Justice Brewer said:

> "Whether the bankrupt was insolvent on August 4, 1898, when he paid the money to his brother, the defendant, and whether the latter had reasonable cause to believe that it was intended thereby to give a preference are questions of fact determined by the verdict of the jury and not open to review in this court."

See also to the same effect *Pyle v. Texas Transport Co.,* 238 U. S. 90, 59 L. Ed. 1215, 35 S. Ct. 667.

The trial court's determination of the factual question of "reasonable cause to believe" should not be disturbed unless clearly erroneous. That rule was laid down by

this court in *Security First National Bank of Los Angeles v. Quittner* (C. C. A. 9th, 1949), 176 F. 2d 997, 999:

> "But where the evidence is such that different conclusions are warranted, the determination of the question here involved is essentially one for the trial court. For even where there is no doubt or controversy as to what facts came to the attention of the creditor, the question as to whether he acted reasonably in making no further inquiries, in short, whether he had reasonable cause to believe the debtor insolvent, is generally a question of fact. * * *.
>
> "And if the evidence here be not such as to require us to find the trial court's findings clearly erroneous, we must accept that court's conclusion. Federal Rules of Civil Procedure, Rule 52(a), 28 USCA."

A review of *all* the evidentiary facts which the trial court had before it cannot fail to impress, appellee feels, that its conclusion that appellant had "reasonable cause to believe" was not only not erroneous but the only correct conclusion which could have been reached.

Firstly, there is the matter of the inspection of Delatorre's books. After appellant had had several months of difficulty collecting its growing account with Delatorre, after Delatorre's checks had been repeatedly returned NSF, after a change in credit terms between appellant and Delatorre had become necessary, after repeated requests for a financial statement had been ignored, at last the manager and his bookkeeper, Elliott, a trained and licensed public accountant [Tr. 94], came to inspect Delatorre's books.

Delatorre made available to them all of his books and Elliott and his superior, Elmo Cross, went through them.

The testimony of the witness Cross taxes the credulity of the appellee for at page 90 of the record he indicates that he and Elliott came to a "rough sketch" of a net worth for Delatorre at the time of the inspection of his books in early June, 1953 of fourteen or fifteen thousand dollars. An actual audit of the books by Raymond Creal, the bookkeeper for Delatorre, made at the end of March, 1953 showed an excess of liabilities over assets of $15,291.00. It is incomprehensible to the appellee how a trained accountant, such as Elliott was, could have inspected the books which, according to Creal, were in substantially the same condition as at the end of March, and misjudged the net worth of Delatorre by as much as $30,000.00.

In this connection, Appellee calls to the court's attention that no effort whatsoever was ever made by the defendant to either produce Elliott or take his testimony and present it to the court on this matter.

Where a creditor is led to make an inquiry as to the actual financial condition of his debtor, he is charged with what that investigation shows, or would show if it were pursued far enough and is therefore chargeable with reasonable cause to believe if the investigation would have revealed insolvency. See *In re Talbot Canning Corp.* (D. C. Md., 1941), 39 Fed. Supp. 858, Rvsd. on other grounds in 125 F. 2d 683.

Appellee contends that when a trained accountant was brought to inspect the books of Delatorre, the appellant cannot now hide behind mistakes which he may have made or the results of a cursory examination. The books were there for the appellant to examine; they were examined by a trained accountant and this charges the appellant with the knowledge of the insolvency of Delatorre which those

books, according to the uncontradicted evidence, had shown for many months.

The second item which the trial court no doubt had in mind was the taking of the chattel mortgage in this matter. While the taking of a chattel mortgage alone may not be determinative, certainly it is a very important factor. The matter is put most strongly in a case decided in the United States District Court of Maine, *Matter of Kents, Inc., Bankrupt,* 9 Fed. Supp. 216. In that case a chattel mortgage was given within four months of bankruptcy to secure an antecedent obligation to a creditor. It is significant for our purposes here that it was given after a check had gone unpaid at the bank. The court was most emphatic in sustaining the element of "reasonable cause to believe", saying:

> "The attorney for the petitioner relies upon a financial statement and the amount for which the property in question was carried on the books of the bankrupt, but a creditor cannot rest on those things alone, where, as here, through his agent and attorney, he knows other facts inconsistent therewith, and especially where he takes a chattel mortgage covering all the stock in trade, tools, and equipment of a small retail business. *That fact alone is sufficient to put him upon inquiry. It is out of the usual course of business, and is evidence of the desperate situation by a mortgagor who does it as a last resort, after his credit is gone, necessarily knowing that it will be close to the end of his financial career.* Many cases, some of them cited by counsel appearing for the trustee, amply bear out this statement. Numerous cases are cited in *Remington* under Section 1919. See also *Pollock v. Jones* CCA 4th) 124 F. 163." (16) (Emphasis supplied.)

The same rule of law was applied in *In Matter of Marcella Chocolate Company* (U. S. D. C. Mass.), 2

A. B. R. (N. S.) 846. The court finding at page 847 of 2 A. B. R. (N. S.):

> "A mortgage like this carried for practical purposes is its own presumptive notice of insolvency * * *."

See also to the same effect:

Pierre Banking and Trust Co. v. Adolph Winkler (S. D. S. Ct., 1917), 40 A. B. R. 622;

In re Brayton (D. C. N. D. N. Y., 1922), 276 Fed. 1020;

In re Clark (D. C. Mich., 1926), 11 F. 2d 540.

The foregoing cases apply most forcibly here. Consider that after a period of financial difficulties between the appellant and Delatorre, after the books have all been inspected, after checks have been repeatedly returned NSF, some of them more than one time, the appellant goes to the place of business of Delatorre, takes an inventory of all of his mortgagable property and insists on this as security for its very substantial claim. What other purpose could there be for such conduct than to protect itself from the possibility that Delatorre would fail and be unable to pay his obligations in full?

In this connection it is also significant to note that the chattel mortgage, which was designated by the counsel for appellant to be a "whip" held over the head of Delatorre, was never recorded. The logical inference to be drawn from such conduct is that the appellant must have known that the recordation of such a chattel mortgage would become known to the general business community and hence to Delatorre's other creditors, of whom appellant had full knowledge after inspecting the books. The court can imagine the rapidity with which Delatorre's operations would have been terminated had other creditors

gotten wind of such an attempt to protect themselves on the part of the appellant.

Appellee insists that the taking of the chattel mortgage is ample indication, even by itself, that the appellant either knew of the dilapidated financial state of Delatorre's business or that they had grave suspicions thereof. Either is sufficient to constitute "reasonable cause to believe".

Counsel for appellant has disregarded all of the foregoing items and chosen to represent to this court that the only basis on which the trial court proceeded was the number of checks which had been returned unpaid to the appellant. Without doubt, this was an important consideration to the trial court, but the foregoing indicates that there were other important factors present.

As to the matter of the checks returned NSF, there have been a number of cases which indicate the importance of this factor.

The United States District Court of Minnesota decided the case of *Robie v. Myers Equipment Co.,* 114 Fed. Supp. 177 in 1953. The case involved substantial payments made by a television retailer to a jobber on an antecedent indebtedness. Part of the proof was that a $5,500 check had been deposited and returned NSF. On this phase of the case the court said:

> "Mere suspicion that a preference is being effected is admittedly insufficient. *Knowledge of dishonored checks* and like information, however, is evidence tending to show reasonable cause for belief in that respect, *and charges the creditor with notice.* Citing *Brown Shoe Co. v. Carns* (CCA 8th) 65 F. 2d 294; *Canright v. General Finance Corporation* (CCA 7th), 123 F. 2d 98; *H. D. Lee Co., Inc. v. Bostian* (CCA 8th), 187 F. 2d 942." (Emphasis supplied.)

A similar conclusion has been reached by the United States District Court of Pennsylvania in the case of *Eisnaugle v. Blank,* 125 Fed. Supp. 390. In that case, checks had been repeatedly returned to Edward Blank & Sons, the defendants. They would put the checks through again at the request of the bankrupt, Schroeder Shoe Co. (Similar to the procedure here.) After several of these checks had been returned, the agent for the defendant went to the Schroeder Shoe Co. and insisted upon a substantial cashier's check to cover the outstanding NSF checks, refusing a further check from the Schroeder Shoe Co. (The parallel to the facts in this case is striking; the checks of Delatorre had "bounced" and after June 1 and the chattel mortgage, the appellant would no longer accept his individual checks but wanted cashier's checks or cash.) The court at page 394 of 125 Fed. Supp. said:

> "I am of the opinion that the evidence establishes that at the time Lester Blank collected the checks in question he had reasonable cause to believe that the financial condition of Schroeder Shoe Co. was precarious and that the company was at that time insolvent. *He knew that certain checks which he had received were unpaid because of insufficient funds. While in the aggregate the sum total of these unpaid checks was not a large amount, it was direct notice to him of the company's financial difficulty."* (394) (Emphasis supplied.)

While the NSF checks in this case standing entirely alone may or may not have been sufficient to support the findings of the trial court, certainly, when coupled with the chattel mortgage, the cessation of credit extension, the examination of the books, the demand for cashier's checks and cash, the effect of the returned checks must be to buttress the finding of the trial court.

Appellee cannot close this brief without commenting on the principal defense to the foregoing facts which appellant continually attempts. The evidence shows without contradiction that a false financial statement had been given by the bankrupt to Dun & Bradstreet and had come to the hands of the appellant, although the time when it was received is not entirely clear. This statement did not reveal the long-standing insolvency of Delatorre. Appellant now continually returns to these financial statements in insisting that it did not have reasonable cause to believe.

Without deprecating the services of so well known and efficient organization as Dun & Bradstreet, appellee submits that a creditor cannot focus all of its attention on only one factor in determining the financial condition of one of its debtors: all the facts must be taken into consideration. And if those other facts are in contradiction to the information supplied by a financial statement, no matter what its source, then a creditor cannot insist blindly upon a state of mind founded only on that financial statement.

Such a conclusion is indicated by the Court of Appeals for the Eighth Circuit in the case of *H. D. Lee Co., Inc. v. Bostian,* 187 F. 2d 942. In that case a contention similar to that made here was made by a creditor. In response thereto, the court said at page 944 of 187 F. 2d:

> "In support of their contention that the trial court erred in finding that the bankrupts were insolvent at the time the payments were made, both defendants rely heavily upon the confidence they placed and insist they were entitled to place in Dun & Bradstreet reports made by James B. Carter * * * in which James B. Carter showed a partnership net worth of $8,150.00 in January, 1947 and of $14,050.00 in January, 1948. * * * *Without minimizing the*

value of such reports as evidence in bankruptcy proceedings or for other purposes, they must be considered in connection with all of the other evidence bearing upon the question of solvency, knowledge thereof, or reasonable grounds for knowledge thereof. And if in the evidence as a whole there be found reasonable support for the trial court's findings, those findings must stand." (944) (Emphasis supplied.)

Conclusion.

Appellee contends that it has demonstrated at the time of trial to the satisfaction of the trial court all of the elements necessary to avoid a preference to a creditor. He has shown the insolvency of Delatorre, the making of payments to the appellant within four months, that the payments were on an antecedent obligation, that the effect thereof was to permit the appellant to receive more payment on its debt than was received by other creditors of the same class. And, finally, that the court's determination of "reasonable cause to believe" is well and broadly supported by the evidence in this case. The entire course of conduct of the appellant in this case is indicative in the strongest terms of one who either actually knew, or had so many items to arouse suspicion as to be charged with the knowledge of the insolvency of the bankrupt.

Respectfully submitted,

CRAIG, WELLER & LAUGHARN,

By C. E. H. MCDONNELL,

Attorneys for Appellee William A. Wylie.

FRANK C. WELLER,

C. E. H. MCDONNELL,

THOMAS S. TOBIN,

Of Counsel.